MANITOBA FRANCHISE GUIDE

Manitoba
Business
Development
and Tourism

SMALL BUSINESS MANAGEMENT SYSTEMS

Table of Contents

I An Introduction to Franchising

A. What is Franchising? ... 3
B. The History of Franchising ... 3
C. Growth of Franchising in Canada ... 4
D. Advantages of Franchising to the Franchisee ... 4
E. Disadvantages of Franchising to the Franchisee ... 4

II Types of Franchises

A. Franchise Formats ... 5
1. Single Unit Franchise ... 5
2. Area Franchise ... 5
3. Master Franchise ... 5

B. The Range of Available Franchises ... 5
1. Fast Foods ... 6
2. Other Food Retailers ... 6
3. Leisure and Travel ... 6
4. Business and Personal Services ... 6
5. Professional Services ... 6

III Legal Requirements of Franchising

A. Canadian Legislation and Disclosure Requirements ... 7
B. United States Based Franchisors ... 7
C. The Franchise Agreement ... 8
1. Obligations Undertaken by the Franchisor ... 8
2. Obligations Imposed Upon the Franchisee ... 8
3. Franchise Fees and Royalties ... 9
4. Purchase of Products and Supplies ... 9
5. Leased Premises ... 9
6. Territorial Protection ... 10
7. Training and Operating Assistance ... 10
8. Contract Duration, Termination and Renewal ... 11
9. Selling or Transferring Your Franchise ... 12

IV Buying A Franchise

A. Finding a Franchise Business ... 13
B. Checking Out the Franchise Opportunity ... 13
C. Applying for a Franchise ... 14
D. Franchise Financing ... 15
1. Short-term Financing ... 15
2. Intermediate-term Financing ... 15
3. Long-term Financing ... 15

V Final Comments

A. Future Trends in Franchising ... 17

Appendix I — Sources of Additional Information ... 18
1. Franchise Associations and Other Organizations ... 18
2. Other Books, Pamphlets and Brochures on Financing ... 18

Appendix II — Checklist for Evaluating a Franchise ... 19

I. An Introduction to Franchising

A. What is Franchising?

Franchising has often been referred to as an industry or a business. However, it is neither. It can best be described as a method of doing business — a means of marketing a product and/or service which has been adopted and used by a wide variety of industries and businesses. There is no simple, single definition of franchising. For example, Statistics Canada defines it as:

> *"A system of distribution in which one enterprise (the franchisor) grants to another (the franchisee) the right or privilege to merchandise a product or service."*

The International Franchise Association, the major trade association in the field, defines franchising as:

> *"A continuing relationship in which the franchisor provides a licensed privilege to do business, plus assistance in organizing, training, merchandising, and management in return for consideration from the franchisee."*

These are just two of the many definitions that have been developed for franchising. All definitions, however, contain the following common elements:

1. A continuing relationship between two parties.
2. A legal contract which describes the responsibilities and obligations of each party.
3. Tangible and intangible assets (such as services, trademarks, and expertise) provided by the franchisor for a fee.
4. The operation of the business by the franchisee under the franchisor's trade name and managerial guidance.

Franchise arrangements can be subdivided into two broad classes:

1. Product distribution arrangements in which the dealer is to some degree, but not entirely, identified with the manufacturer/supplier.
2. Entire business format franchising, in which there is a complete identification of the dealer with the supplier.

In a product distribution arrangement the franchised dealer concentrates on one company's product line and, to some extent, identifies his/her business with that company. Typical of this type of franchise are automobile and truck dealers, gasoline service stations, and soft drink bottlers.

Business format franchising is characterized by an ongoing business relationship between the franchisor and franchisee that includes not only the product, service, and trademark, but the entire business format itself — a marketing strategy and plan, operating manuals and standards, quality control, and continuing two-way communications. Restaurants, personal and business services, rental services, real estate services and many other businesses fall into this category of business format franchising.

Business format franchising has been primarily responsible for most of the growth of franchising in Canada since 1950. Most of our comments throughout the rest of this publication will relate to this form of franchising.

B. The History of Franchising

Some writers place the origin of franchising in Europe prior to the 18th century when German and English brewers entered into licensing and financing arrangements with tavern owners for the exclusive sale of their brand of beer and ale. Others have speculated that the first license/franchise was granted by Queen Isabella of Spain to Christopher Columbus for the purpose of finding a new route to the East. While other early forms of franchising can be identified, the use of this distribution method was probably of little importance prior to its introduction in the United States. The earliest recognized form of franchising in the U.S. was by the Singer Sewing Machine Company soon after the end of the Civil War.

At the beginning of the 20th century, advances in technology and improved transportation and communications set the stage for our mass production society. Manufacturers and producers realized that the distribution of their products would be a key factor in their success. Two industries, the soft drink and automobile industries, were among the earlier adopters of the franchise distribution method. Firms in these industries have since become the giants in the franchise field.

The years following World War II saw a tremendous increase in the popularity of the franchising concept. With the increasing mobility of the North American public and the growing importance of services in the economy, new categories of franchised operations were developed. These included accounting and business services, automobile and trailer rentals, motels and hotels, rental equipment outlets, counselling services, recreation services, cleaning establishments, and particularly fast-food restaurants.

In the latter part of the 1960's, the bubble burst due to poor business conditions, bad management, over expansion, and the entry of a number of questionable operators into the industry. During this interval many franchisors went bankrupt and only franchises built on a strong foundation arrived.

After this setback, franchising entered a retrenchment stage. During this retrenchment, growth slowed considerably, particularly that of the fast-food outlets. However, since the mid 1970's, franchising has started to grow again, but this growth has been more moderate than during the previous boom period. This is attributable to a number of factors:

1. As a result of the bad reputation gained by franchising in the late 1960's, bankers became more hesitant in backing people with little or no business experience as franchisees.
2. Trade regulations and legislation became more restrictive of the activities of franchisors and made franchising less profitable.
3. The primary reason many franchisors had chosen this method to expand (a lack of capital) was no longer as valid. Previously successful firms now had sufficient capital to expand through company owned outlets rather than franchises.
4. The trend was more toward corporate and professional operators with substantial financial backing as franchisees. They could handle a number of franchise units unlike the "mom and pop" type franchisees of the 1960's.
5. Franchisors began to organize. The Association of Canadian Franchisors was formed in 1967 and now has more than 130 members. The International Franchise Association and the National Franchise Association were also formed in the United States.

6. Finally, a number of the more successful firms which used the franchise distribution system appeared to have reached a point of saturation in their domestic markets.

Over the past several years, franchising has built a more solid base and expanded to many new areas such as automobile products, income tax services, cosmetics, hair and beauty salons, computers, and even real estate and travel agencies. Franchising has matured. Its growth rate is steady and, once again, many large and established companies see it as an attractive way to expand their operations.

C. Growth of Franchising in Canada

There are approximately 42,000 franchised business establishments in Canada. They have been established by 1,700 franchisors, 500 of whom are still actively selling franchises. It is estimated that in 1984 these franchised outlets accounted for 30% of all retail sales or approximately $54 billion worth of business. From 1969 to 1982 franchise sales grew at a compound annual growth rate of almost 11%, far in excess of that of the rest of the Canadian economy. These are impressive growth statistics.

In North America, total sales of franchised businesses have surpassed 430 billion dollars. The growth of franchising during the past couple of years has, in fact, been contracyclical to that of the rest of the economy and franchising is expected to continue to grow at a rate significantly greater than that of any other business activity in Canada.

D. Advantages of Franchising to the Franchisee

Franchising is one means for you (the franchisee) to go into business for yourself, but yet at the same time also be part of a chain, with the support of an established company (the franchisor) behind you. This can enable you to compete with other chains through the use of a well-known trademark or trade name. In addition, the franchisor may provide you with assistance in such areas as site selection, equipment purchasing, national advertising, bookkeeping, the acquisition of supplies and materials, business counselling, and employee training.

As a franchisee, you will have the opportunity to buy into an established concept with reduced risk of failure. Statistics show that a typical franchisee has an 80% chance of success. Several factors may explain this result. First, the risk is reduced because the franchisee is supposedly buying a successful concept. This package includes proven and profitable product or service lines, professionally developed advertising, a known and generally recognized brand name, the standardized design or construction of a typical outlet, and a proven and market tested operating system. Second, the franchisee is often provided with training for the new job and continuing management support. You have the ongoing assistance of the franchisor, who can afford to hire specialists in such areas as cost accounting, marketing and sales, and research and development. These are important assets which are usually not available to the small, independent businessperson.

A franchisee may also be able to take advantage of the lower cost of large scale, centralized buying. You may be able to purchase supplies at reduced cost since the franchisor can purchase in bulk and pass the savings along. You may also have access to financing and credit arrangements that would not otherwise be available to an independent business. Chartered banks and other lending institutions are usually more willing to lend money to a franchisee who has the backing of a large, successful franchisor than they are to a completely independent business.

A franchisee has the opportunity to acquire a proven system which has already been developed, tested and refined, with all of the bugs worked out. This allows you to avoid a lot of the start-up problems typically associated with starting an independent business.

E. Disadvantages of Franchising to the Franchisee

While franchising has a considerable number of advantages for prospective franchisees, there are also several disadvantages of which you should be aware. One of the principal complaints is the degree of control which franchisors exert over their franchisees. While you will be an independent businessperson, in effect you do not have complete autonomy and must operate within the operating system as defined by the franchisor. You are usually in a subordinate position to the franchisor and must abide by the often extremely rigid terms and conditions of the franchise agreement. All franchise contracts give the franchisor either an open right to terminate the contract or the right to terminate upon breach of the agreement. As a result, you may find yourself in a weak bargaining position.

Franchisees also have certain reporting obligations to the franchisor and may be subject to frequent inspection and constant supervision. To fit comfortably into such an arrangement, you must accept the necessity of such controls. These restrictions, however, may be unacceptable to some individuals. As a result, you must seriously assess your personal suitability for the role of a franchisee.

Another disadvantage of franchising is that the cost of the services provided to you by the franchisor is based on your total sales revenue. These costs can amount to 10% or more of your total revenue or an even larger share of your profits. A related complaint is the markup that the franchisor may add to the products you must buy from him or her can increase your operating costs, particularly if equally good products could be purchased elsewhere at lower prices. While you might initially feel that your operating costs are likely to be lower as a result of the franchisor's central purchasing program, it may not become apparent until later that you are actually paying a huge markup on material, equipment and supplies acquired from the franchisor.

Unfortunately the benefits available through franchising have not always materialized. Franchisors have not always supplied the services they promised or truthfully disclosed the amount of time and effort the franchisee would have to commit to the franchise. Termination policies of many franchisors have given franchisees little or no security in many cases. Acquiring a franchise is not necessarily a license to print money. Besides an initial franchise fee, you will probably also have to make periodic royalty payments and advertising contributions based on a percentage of your gross revenues. Even with these expenditures, you still run the risk of not achieving the expected sales, and thus the profit, which the franchisor stated were possible when initially selling you the franchise.

II. Types of Franchises

A. Franchise Formats

1. *Single Unit Franchise* — The most popular and simplest franchise format is the single unit franchise where the franchisor grants to you the right to establish and operate a business at a single location. Historically this has been the most popular means of franchise expansion and the method by which many independent entrepreneurs have become involved in franchise distribution.

2. *Area Franchise* — An area franchise involves a franchisor granting to you the right to establish more than one outlet within a specified territory. This territory can be as large as an entire province or even a country, or as small as a part of the city. To assure that this territory is adequately serviced, the franchisor will usually require the construction and operation of a specific number of outlets within a period of time. Area franchising may be a means of achieving certain economies of scale and, perhaps, a lower total franchise cost. It does, on the other hand, require a larger capital outlay for plant and equipment. Area franchisees with a large number of outlets can sometimes acquire greater financial strength then their franchisors. This has happened in a number of instances in the fast food industry.

3. *Master Franchise* — With the master franchise, a franchisor grants to you (the master franchisee) the right, not only to operate an outlet in the specific territory, but also to sell subfranchises to others within that same territory. The granting of master franchises is the fastest means for a franchisor to expand but is also very complex, and results in a division of fees and royalties between the franchisor and subfranchisor. A master franchisee may not need as much initial capital as an area franchisee but must learn not only how to open and operate a franchise business but also how to sell franchises.

B. The Range of Available Franchises

To give you an idea of the current scope of franchising the Franchise Opportunities Handbook published by the United States Department of Commerce lists almost 1300 different franchise organizations in 42 product/service categories. The range of possibilities available to a prospective franchisee include opportunities in the following product/service areas:

— automotive products/services;
— auto/trailer rentals;
— beauty salons/supplies;
— business aids/services;
— campgrounds;
— children's stores/furniture/products;
— clothing/shoes;
— construction/remodelling/services;
— cosmetics/toiletries;
— dental centres;
— drug stores;
— vacational products/services;
— employment services;
— equipment/sales/rentals;
— foods — doughnuts;
— foods — grocery/specialty;
— foods — ice cream/yogurt/candy/popcorn/beverages;
— foods — pancakes/waffles/pretzels;
— foods — restaurant/drive-ins/carry-out;
— general merchandise stores;
— health aids/services;
— hearing aids;
— home furnishings/furniture — retail/repair/services;
— insurance;
— laundries, drycleaning — services;
— lawn and garden supplies/services;
— maintenance/cleaning/sanitation — services/supplies;
— motels, hotels;
— optical products/services;
— paint and decorating supplies;
— pet centres;
— printing;
— real estate;
— recreation/entertainment/travel — services/supplies;
— retailing — art supplies/frames;
— retailing — computer sales/services;
— retailing — florists;
— retailing — not elsewhere classified;
— security systems;
— swimming pools;
— tools;
— hardware;
— vending;
— water conditioning;
— miscellaneous wholesale/service businesses.

Within this broad spectrum of available opportunities, the most popular areas have been fast food, other retail food stores, leisure and travel, business and personal services, and professional services.:

1. *Fast Foods* — A typical fast food outlet has a limited menu as well as take out service. This is the traditional type of fast food operation, although some forms of sit-down restaurants are also moving into this field. The fast food field is extremely broad covering everything from hamburgers, hotdogs, french fries, and milkshakes, to pizza, bar-b-que beef or ribs, fried chicken, steaks, mexican food, sea food, pancakes and waffles, roast beef sandwiches and so on.

2. *Other Food Retailers* — Other food retailers include convenience food stores such as Mac's Milk and 7-Eleven stores as well as a broad range of specialty retailers selling items such as health foods, doughnuts and ice cream, coffee service outlets, bakeries, and so on. Convenience stores offer consumers the many, everyday fill-in items that they need between regular visits to the supermarket. These convenience stores have grown substantially in both number of outlets and dollar sales volume over the past few years. We are now seeing growing numbers of convenience stores associated with the major gasoline retailers such as Shell, Gulf, Texaco and Imperial Oil.

3. *Leisure and Travel* — In the past decade or so, the leisure and travel industry has grown at a fantastic rate. Included in this industry (from a franchise perspective) are travel agents, sun tan parlors, hotels, motels, campgrounds and other recreation, entertainment, and travel businesses.

4. *Business and Personal Services* — There has been an increasing demand for many diverse business and personal services over the past few years, providing many opportunities for franchisees. In the area of leasing and rental services, the largest category is the passenger car and truck rental business. In addition there seems to be an increasing trend towards renting other kinds of equipment such as gardening supplies, tools, party supplies and video cassettes/movies. In the category of business aids and services there are many varied and specialized franchises including accounting services, employment services, general business systems, printing and copying firms, tax preparation companies, and many similar types of businesses. Also included in this category would be suppliers of engineering and marketing consulting services, security system franchises, and franchised real estate companies.

5. *Professional Services* — Professionals have only recently started to franchise and we will probably see the continuing emergence of franchised accounting offices, legal clinics, and medical and dental facilities among others.

III. Legal Requirements of Franchising

A. Canadian Legislation and Disclosure Requirements

Although many states in the United States have laws and regulations governing franchise companies, the same is not true in Canada. Only Alberta has a Franchise Act although Ontario and Quebec have discussed the implementation of similar legislation. The Alberta legislation requires franchisors wishing to sell franchises in that province to disclose the material facts involved in operating the franchise. This involves filing a prospectus with the Alberta Securities Commission. This prospectus outlines the franchisor's financial capabilities, the history of the franchise company and provides information on its officers and directors. Other details the franchisor must file with the Commission are:

— a list of all company officers and directors;
— a brief history of the company;
— a list of major shareholders in the company;
— disclosure of any previous bankruptcies among outlets or officers and directors;
— notice of any outstanding litigation against the company;
— copies of all contracts to be signed by the franchisee;
— the amount of investment required by the franchisee;
— a list of all Alberta franchisees and;
— a copy of the firm's financial statements.

In Alberta a prospective franchisee is entitled to a copy of this prospectus. This is not the case for franchisees in other provinces. Franchisors do not have to file a prospectus with the other Canadian provincial governments. So, for the most part, as a franchisee you may be on your own. However, if the franchisor operates in Alberta, you should request a copy of this prospectus or you can obtain a copy from the Franchise Division of the Alberta Securities Commission at a nominal cost.

Remember that the Alberta legislation is merely a disclosure-registration statute and not a regulatory statute. It is intended to provide protection to the public through requiring full, plain and true disclosure of all material facts relating to a franchise being offered and provides no assurance or guarantee that the franchise will be successful or that the franchisee will ever make a profit.

B. United States Based Franchisors

About one third of the franchise organizations operating in Canada are based in the United States. These franchisors have two ways of operating in this country. They can operate entirely from the U.S. without any company-owned offices in this country or they may grant an area franchise to a Canadian franchisor with the Canadian company then becoming responsible for franchisee selection, training, advertising, and other aspects of the franchisor/franchisee relationship.

Since 1979 the U.S. Federal Trade Commission has required that every franchisor offering franchises in the United States have a disclosure statement ready to offer a prospective franchisee. A copy of this disclosure statement can be obtained from the Federal Trade Commission in Washington, D.C. This basic disclosure document consists of 20 categories of information:

1. Identifying information about the franchisor;
2. Business experience of the franchisor's directors and key executives;
3. The franchisor's business experience;
4. Litigation history of the franchisor and its directors and key executives;
5. Bankruptcy history of the franchisor and its directors and key executives.
6. Description of the franchise;
7. Money required to be paid by the franchisee to obtain or commence the franchise operation;
8. Continuing expenses to the franchisee in operating the franchise business that are payable in full or in part to the franchisor or to a person affiliated with the franchisor;
9. A list of persons who are either the franchisor or any of its affiliates, with whom the franchisee is required or advised to do business;
10 Real estate, services, supplies, products, inventories, signs, fixtures or equipment which the franchisee is required to purchase, lease or rent, and a list of any persons with whom such transactions must be made;
11. Descriptions of consideration paid (such as royalties, commissions, etc.) by third parties to the franchisor or any of its affiliates as a result of a franchisee's purchase from such third parties;
12. Description of any franchisor assistance in financing the purchase of a franchise;
13. Restrictions placed on a franchisee's conduct of the business;
14. Required personal participation by the franchisee;
15. Termination, cancellation, and renewal of the franchise;
16. Statistical information about the number of franchises and their rate of termination or failure;
17. Franchisor's right to select or approve a site for the franchise;
18. Training programs for the franchisee;
19. Celebrity involvement with the franchise; and
20. Financial information about the franchisor.

The F.T.C. regulations also require that if the franchisor makes any claims regarding the level of earnings a prospective franchisee might realize as a result of owning the franchise, then a reasonable basis must exist to support the accuracy of these claims. When such claims are made the franchisor must prepare an Earnings Disclosure Document to furnish each prospective franchisee explaining the basis and material assumptions on which these earning claims have been made.

You should realize that Canadian franchisors are under no obligation to provide ar.y comparable disclosure information to their prospective franchisees. When investigating a franchisor you should try to obtain the information indicated as forming part of a disclosure statement independently if it is not available from other sources. In addition to obtaining as much information as you can and conducting your own investigation of the opportunity, you may also wish to consult a lawyer and an accountant before investing in any franchise.

C. The Franchise Agreement

Because two independent parties participate in a franchise relationship, the primary vehicle for obtaining central coordination and control over the efforts of both participants is a formal contractual agreement. This contract is the heart of the franchise relationship. A franchise agreement differs from the typical contract in that it contains restrictive clauses peculiar to franchising which limit the franchisee's rights and powers in the conduct of the business. Franchisors argue that these controls are necessary in order to protect their trademark and to maintain a common identity for franchised outlets.

A typical franchise agreement covers a variety of activities. Some of these include provisions governing the initial fee and royalty payments, use of the franchisor's trademark by the franchisee, the sale and purchase of products, facilities required, inventory, pricing, advertising, duration of the agreement, termination of the agreement, operating procedures, and accounting methods to be followed by the franchisee.

In considering any franchise proposition you should pay a great deal of attention to the franchise contract. It is a key part of the relationship and should be thoroughly understood by all parties concerned. The following discussion concentrates on the evaluation of an agreement for a single unit franchise relating to a business format franchise system. This discussion deals with areas of concern for both franchisors and franchisees. However, it is important to realize that there is really no such thing as a "typical" franchise agreement. While agreements may follow a fairly standard approach in terms of format, they do not necessarily do so in terms of content. Each agreement is drafted specifically by the franchisor to reflect particular objectives and the nature of the franchise business.

1. Obligations Undertaken by the Franchisor

The obligations undertaken by the franchisor may include any or all of the following activities:

a. The franchisor may provide basic business training to the franchisee and his/her employees. This may include training in bookkeeping skills, staff selection, staff management, business procedures, and the systems necessary to control the franchise operation. In addition, the franchisor may provide the franchisee with training relating to the operational details of the business.

b. The franchisor may investigate and evaluate sites for the location of the franchise for the franchisee. The franchisee will be advised as to whether or not the site meets the franchisor's standards and what sort of performance might be expected at that location. In addition the franchisee will be assisted in the design and layout of the franchise operation.

c. The franchisor may either provide the equipment or the specifications for any necessary equipment and furniture required by the franchisee.

d. The franchisor may provide promotional and advertising material to the franchisee as well as some guidance and training on marketing and promotional principles.

e. The franchisor may provide the franchisee with a statement indicating the amount of opening inventory required, and may make arrangements for the franchisee to purchase inventory either from the franchisor's own purchasing department or from particular suppliers established for this purpose.

f. The franchisor may provide the franchisee with on-site assistance for the opening of the franchise outlet. Quite often the franchisor will provide a team of 2 to 3 people to assist the franchisee in getting the business off the ground.

g. The franchisor may also provide business operating manuals explaining the details of operating the franchise system as well as a bookkeeping/accounting system for the franchisee to follow. The franchisor may also provide support to the franchisee through such things as business consultation, supervisory visits to the premises, and staff retraining.

2. Obligations Imposed Upon the Franchisee

The obligations of the franchisee may include any or all of the following:

a. To build the franchise outlet according to the plan or specifications provided by the franchisor.

b. To maintain construction and opening schedules established by the franchisor.

c. To abide by the lease commitments for the franchise outlet.

d. To observe certain minimum opening hours for the franchise.

e. To pay the franchise and other fees specified in the franchise agreement.

f. To follow the accounting system specified by the franchisor and to provide financial reports and payments of amounts due promptly.

g. To participate in all regional or national cooperative advertising and to use and display such point of sale or advertising material as the franchisor stipulates. This would include having all advertising materials approved by the franchisor.

h. To maintain the franchise premises in a good, clean, sanitary condition and to redecorate when required to do so by the franchisor.

i. To maintain the required level of business insurance coverage.

j. To permit the franchisor's staff to enter the premises to inspect and see whether the franchisor's standards are being maintained by the franchisee.

k. To purchase specific goods or services from the franchisor or specified suppliers.

l. To train all staff in the franchisor's method and to ensure that they are neatly and appropriately dressed.

m. Not to assign the franchise contract without the franchisor's consent.

n. To maintain adequate levels of working capital and to abide by the operations manual provided by the franchisor.

These are examples of some of the obligations you might expect to incur in signing a franchise agreement. In addition, there will probably also be clauses involving bankruptcy, transfer of the business, and renewal of the contract, as well as provisions for the payment of royalties and other financial considerations.

3. Franchise Fees and Royalties

In most cases you will be required to pay an initial franchise fee on signing the franchise agreement. This initial fee generally includes the right to use the trade name, licenses, and operating procedures of the franchisor, as well as some initial training and, perhaps, even assistance in site selection for the franchise outlet. The amount of the fee varies tremendously, depending on the type of franchise business. For a large restaurant operation or hotel, for example, the fee may be as high as $50,000 or $60,000, but for a small service franchise (such as maid service or lawn care) it may be only $5,000 to $10,000. This fee is not all profit for the franchisor as it must go to pay for franchisee recruitment, training, assistance with site selection, and other services normally provided to the franchisee. Some franchisors will charge a separate training fee but this is usually established merely to recover the cost of providing the training to the franchisee and his/her employees.

In addition to this initial franchise fee, continuing fees may also be provided for in the franchise agreement. These fees will generally consist of royalties payable for the ongoing rights and privileges granted by the franchisor. The royalty fees are usually calculated as a percentage of the gross sales generated by the franchise business. These royalty fees may be paid weekly, monthly or quarterly and represent the main profit center for most franchisors. Typical royalties range from 3 to 8% for a fast food franchise. For some service franchises the royalty may run from 10-20% or even higher.

In addition to royalty fees, many franchise agreements require the franchisee to contribute a proportion of the business's gross revenues to a regional or national cooperative advertising fund. This contribution may be an additional 2-4% of gross sales. These payments are used to develop and distribute advertising material and to run regional and national advertising campaigns. They are typically not a source of profit for the franchisor. The advertising fund should be maintained as a separate trust account by the franchisor and not intermixed with general operating revenues. The purpose of this fund should be specified in the franchise agreement. In addition, the agreement should also state how and by whom the fund will be administered. The administration of these advertising funds has often been the subject of considerable concern to franchisees and one of the areas of greatest dispute between franchisors and franchisees.

In addition to supporting a regional or a national advertising program, a franchisor may also require the franchisee to make expenditures for local advertising. An agreement may require the franchisee to spend a specific amount on a periodic basis, calculated either on the basis of a percentage of gross sales or in terms of a fixed amount. This local advertising will normally require prior approval by the franchisor.

In some cases the franchisor also provides special services such as bookkeeping, accounting, and management consulting services to the franchisee which are billed on a fee for service basis. Before acquiring a franchise, you should be sure that you understand all the fees that will be payable, including any extra fees that may not be mentioned in the franchise agreement.

4. Purchase of Products and Supplies

A key element in the success of many franchise organizations is the sameness of each of the franchise outlets. Therefore, the franchisor will work to ensure the maintenance of a certain quality of product or service and to make sure that uniform standards are employed throughout their system. Consequently, many franchisors, in an attempt to exercise complete control over their operation, require franchisees to purchase many products and services from themselves or designated sources. In some cases, the approved suppliers may include affiliates of the franchisor. The franchisee may also be able to purchase some items from other sources of supply provided that the franchisor has approved each of those sources in advance.

If the franchisor exerts tight control over such supplies, you should try to ensure in advance that they are going to be readily available when required, sold to you at fair market value and on reasonable terms, and that you have the ability to choose alternative sources of supply for any nonproprietary items if the franchisor or the designated supplier is unable to provide them to you when required.

Many franchisors earn a profit from providing supplies to their franchisees. Often, however, because franchisors exercise enormous buying power, they can supply goods and services at prices and under terms which are better than those which individual franchises could negotiate for themselves. Potential franchisees should shop around to compare prices for comparable merchandise. If the prices being charged by the franchisor are out of line, this added cost can dramatically affect the business's future earnings.

Volume rebates are often paid to franchisors by suppliers of particular products. Rather than pocket the money themselves or distribute it back amongst the franchisees, some franchisors will contribute this to the advertising fund. As a potential franchisee you should ask how these rebates will be handled as a considerable amount of money may be involved.

5. Leased Premises

Many franchise operations require the use of physical facilities such as land and buildings. Where these premises are leased rather than owned by the franchisee, there are a number of ways in which this lease arrangement can be set up:

a. The franchisor may own the land and/or building and lease it to the franchisee.

b. The franchisee may lease the land and/or building directly from a third party.

c. The franchisee may own the property, sell it to the franchisor, and lease it back under a "sale leaseback" agreement.

d. A third party may own the property and lease it to the franchisor, who then sub-leases it to the franchisee.

The franchise agreement should spell out who is responsible, you or the franchisor, for negotiating the lease, equipping the premises, and paying the related costs.

If a lease is involved, its terms and renewal clauses should be stated and correspond with the terms of the franchise. You must be careful not to have a 20 year lease on a building and only a 5 year franchise agreement, or vice versa.

Franchisors generally want to maintain control of the franchise premises. Accordingly they will often own or lease the property on which the franchise business is located, and then sub-lease these premises to the franchisee. In other situations the franchisor may assign a lease to the franchisee subject to a conditional reassignment of the lease back to the franchisor upon termination of the franchise for any reason.

If the franchisee enters directly into a lease for the premises, the franchisor will normally require that the lease contain some provisions protecting his/her interests. These provisions may include notice to the franchisor of any default by the franchisee under the lease, the right upon termination or expiration of the franchise agreement to assume the franchisee's status under the lease, the right to enter the premises and make any modification necessary to protect the franchisor's trademarks or the integrity of the franchise system, a covenant prohibiting assignment or sub-lease by the franchisee without the prior consent of the franchisor or a provision authorizing the leasor to disclose to the franchisor any information furnished by the franchisee.

With respect to other leasehold improvements, the franchisee may also be required to purchase or lease from the franchisor or from suppliers designated by the franchisor, certain fixtures, furnishings, equipment and signs that the franchisor has approved as meeting particular specifications and standards.

6. Territorial Protection

In many cases the franchise agreement provision with respect to territory and protection of that territory for the franchisee may be subject to considerable negotiation prior to inclusion in the agreement. You will generally want to have the franchisor agree not to operate or grant a franchise to operate another franchised outlet in close proximity to your operation. This restriction may be confined to a designated territory, or may be confined to a predetermined geographic radius from your premises.

Franchisors, on the other hand, like to see exclusive territorial protection kept to a minimum. As a result, some franchisors may restrict the protection for the franchisee to the grant of first refusal to the franchisee to acquire an additional franchise within the territory, or may subject the franchisee to a performance quota in terms of a prescribed number of outlet openings in order to maintain exclusivity within the territory. Another approach taken by some franchisors is to limit exclusivity to a formula based on population with the result that when the population within a territory exceeds a specified number, the franchisor may either operate, or grant a franchise to operate, an additional outlet in the territory.

Franchisees typically attempt to negotiate some degree of territorial protection for themselves, however, if for no other reason than to prevent franchisor-owned or company-operated outlets from competing directly with them.

Some questions you might like to have answered in the franchise agreement are:

a. Exactly what are the geographic boundaries of your territory, and are they marked on a map as part of the contract?

b. Do you have a choice of other territories?

c. What direct competition is there in your territory, and how many more franchises does the franchisor expect to sell in that area within the next five years?

d. If the territory is an exclusive one, what are the guarantees of this exclusivity?

e. Even with these guarantees, will you be permitted to open another franchise in the same territory?

f. Can your territory be reduced at any time by the franchisor?

g. Has the franchisor prepared a market survey of your territory? If so, ask for a copy of it and study it.

h. Has the specific site for the franchise within the territory been decided? If not, how and when will this be done?

7. Training and Operating Assistance

Virtually every franchise agreement deals with the question of training of the franchisee. The content, length of time and location of the training program should be specified in the agreement. These training programs may consist of training schools, field experience, training manuals or on location training.

The franchise program should have provision for an initial training program for the franchisee and the agreement should specify the duration and location of this training, and who is responsible for the transportation, accommodation and living expenses of the franchisee during this program. This initial training is generally provided for the franchisee and the manager of the franchise business. The franchisor will usually require the franchisee and his/her managers to complete the training program successfully prior to the opening of the franchise business. If, for some reason the franchisee should fail to complete the training program, the franchisor often reserves the right to terminate the franchise agreement and refund all fees, less any costs incurred to that point in time.

Many franchise agreements also provide for a start-up advisory training program at the franchise premises prior to or during the opening of the business. This typically involves a prespecified number of days. The agreement should indicate who is expected to bear the cost for such start-up training including who will be responsible for the payment of travel, meals, accommodation and other expenses of the franchisor's supervisory personnel.

The franchise agreement may also make reference to periodic refresher training programs for the franchisee. It should specify whether attendance at such programs is optional or mandatory. If these programs are mandatory, the franchisee should ensure that a specified maximum number of such programs is indicated for each year of the franchise agreement. The duration and location of these programs should also be specified.

Most franchisors want tight control over the day-to-day operations of the franchise and, as a result, provide extensive operating assistance to their franchisees. This assistance is often in the form of a copyrighted operations manual that spells out, procedure by procedure, the ways in which you are expected to run the business. It will include such information as the franchisor's policies and procedures, and covers such details as the hours you must remain open, record keeping methods and procedures, procedures for hiring and training employees, and, in a restaurant franchise such matters as recipes, portion sizes, food storage and handling procedures, and menu mix and selling prices. The franchise agreement may also indicate that operating assistance will be provided in relation to:

a. The selection of inventory for your franchise business;

b. Inspections and evaluation of your performance;

c. Periodic advice with respect to hiring personnel, implementing advertising and promotional programs, and evaluating improvements in the franchise system;

d. Purchasing goods, supplies, and services;

e. Bookkeeping and accounting services;

f. Hiring and training of employees;

g. Formulation and implementation of advertising and promotional programs;

h. Financial advice and consultation;

i. Such additional assistance as you may require from time to time.

8. Contract Duration, Termination and Renewal

The duration of the franchise agreement may be as short as one year or as long as 40 to 50 years. However, the majority of franchise contracts run from 10 to 20 years. Most agreements also contain some provision for renewal of the contract. Be sure that you understand these renewal provisions and what the terms, conditions and costs of renewal will be. Renewal provisions commonly contain requirements for the payment of additional fees and upgrading of the franchise facilities to the standards required by the franchisor at that time. The cost of this upgrading is usually borne by the franchisee. You should be aware, however, that not all agreements necessarily contain provisions for their renewal at the expiration of the initial term. Some agreements merely expire at the end of this term and the rights revert back to the franchisor.

The parts of the franchise agreement usually considered most offensive by many prospective franchisees are those sections relating to termination of the agreement. Franchisors typically wish to develop a detailed list of items by which a franchisee might be considered in default of the agreement. Events of default typically fall into two categories, the first consisting of critical or material events which would allow for termination of the agreement without notice by the franchisor, and the second where the franchisee is first given written notice with an opportunity to correct prior to the franchisor being entitled to terminate the agreement.

Events of default which might be considered as critical or material would include:

a. Failure to comply with requirements concerning location and leasing of premises;

b. Failure to complete all required training;

c. If the franchisee commits an act of bankruptcy or becomes insolvent;

d. If a receiver or other custodian is appointed to the franchise business;

e. If the franchisee fails to actively and continuously operate the franchise business;

f. If the franchisee attempts to make any unauthorized assignment, transfer or sale of the franchise business;

g. If the franchisee willfully or fraudulently misrepresents any fact, condition or report made under the franchise agreement;

h. If the franchisee understates gross sales by a specified percentage on a specified number of occasions during the term of the agreement; and,

i. If the franchisee fails to make payment of any amount required to be paid to the franchisor or any affiliate of the franchisor under the franchise agreement.

Events of default which would normally require the franchisor to give the franchisee written notice and an opportunity to rectify the situation include:

a. Unauthorized use of the franchisor's trademarks;

b. Engaging in conduct that, in the opinion of the franchisor, reflects unfavorably upon the goodwill or reputation of the franchise; and

c. Failure to observe, perform or comply with any provision, term or obligation contained in the franchise agreement.

These termination provisions exist to protect the integrity of the franchise system. If one franchisee breaks the law or is in financial difficulty or acts in such a way as to damage the reputation of the entire franchise system, it naturally reflects on all franchises. To prevent this from happening, franchisors try to retain the right to be able to take immediate corrective action based on the provisions of the franchise agreement.

To make its claim of franchisee default stick, the franchisor must be able to provide the courts with written evidence that proper procedures have not been followed. For example, a franchisor cannot merely walk into a franchisee's operation and announce that they are terminating the contract because of a failure to maintain some provision of the franchise agreement. To support their case the franchisor must usually have a file of documentation indicating that the franchisee has been well informed of this breach of contract and some evidence of refusal to rectify the problem. In order for a franchisor to effectively terminate the franchise agreement, the breach of contract usually has to involve something that is considered to be significant or material.

In the event of termination or expiration of the franchise agreement, the franchisee will normally be required to agree to the following items:

a. Pay all amounts due or owing to the franchisor or any affiliate of the franchisor;

b. Immediately return to the franchisor all copies of the operations manual;

c. Notify the telephone company and listing agencies of the termination of the franchisee's right to use all telephone numbers and all classified and other directory listings of the franchise business, and authorize such authorities to transfer to the franchisor all such numbers and listings;

d. Immediately cease operation of the franchise business;

e. Cease to use the trademarks, and any confidential methods, procedures and specifications associated with the franchise system;

f. Discontinue using any equipment, signs, fixtures, furnishings, advertising materials or other products or materials which display the trademarks or any distinctive feature associated with the franchise system;

g. Cancel any permitted business name registrations incorporating the trademarks of the franchisor; and,

h. Modify the appearance, both exterior and interior, of the premises as the franchisor might feel is necessary.

Most franchise agreements also allow the franchisor the right, upon termination or expiration, to purchase from the franchisee all inventory, supplies, equipment, furnishings, leasehold improvements and fixtures owned or used by the franchisee in connection with the franchise business. The method of calculation of the purchase price of such items is entirely negotiable by the parties prior to the execution of the franchise agreement. This has been another area of considerable dissention between franchisors and franchisees.

Some franchise agreements make provision for arbitration procedures in the event of a dispute between the francnisor and the franchisee regarding this provision. There is considerable difference of opinion, however, as to whether arbitration is really a useful procedure. While arbitration can be faster and less costly in terms of resolution of the dispute, it is subject to the competence of the arbitrator. There is also a limited right of appeal for both parties from the results of the arbitration.

As previously mentioned, many franchise agreements allow for renewal for one or more terms of length equal to that of the initial term of the contract. But there are some successful Canadian franchisors who make no provision for renewal, or for the franchisee to sell the business at the end of the initial contract term. The duration of this original agreement is extremely important because it defines the time period during which you will have to service your original debt as well as make a reasonable return on that investment. In some franchise operations, it can take 3 or 4 years to recover all the up-front costs. If the term of the agreement is only 5 years, that does not leave a great deal of time to earn much of a return on that initial investment. This opportunity is further reduced if there is no chance for renewal of the agreement.

When renewing franchise agreements, many franchisors do not require the payment of an additional franchise fee, but they may require franchisees to pay the current, and usually higher, royalty fees and advertising contributions. These increases, of course, reduce the income of the franchisee. In addition, the franchisor may require renewing franchisees to make substantial leasehold improvements, update signage and make other renovations to their outlet in order to conform to current franchise system standards. These capital expenditures can be expensive so it should be clear from the beginning what, if any, improvements might be required upon renewal.

9. Selling or Transferring Your Franchise

With respect to assignment, transfer or sale of the franchise by the franchisee, most franchise agreements indicate that the franchisee is granted rights under the agreement based on the franchisor's investigation of his or her qualifications. These rights are typically considered to be personal to the franchisee. As a result, the contract will usually require you to agree that assignments will be prohibited without the approval of the franchisor. You should, at least, attempt to have the franchisor agree that such consent will not be unreasonably withheld.

For self protection, you should be sure that the agreement contains provisions for the transfer of the franchise to your spouse or an adult child upon your death. Also it should be possible to transfer the franchise to a corporation which is 100% owned by you and has been set up solely to operate the franchise. These transfers should be possible without the payment of additional fees.

Most franchisors, however, require that transfer of the franchise to an external party meet their normal criteria of technical competence, capital and character. You may be able to enhance the marketability of your franchise by anticipating these and other problems in the initial negotiations.

Another common provision is for the franchisor to have the right of first refusal or option to purchase the franchise in the event that you receive an offer from an independent third party to acquire your rights. In such a situation you may be required to first offer such rights back to the franchisor under the same terms and conditions offered by the independent third party. If the franchisor declines to acquire your rights within a specified period of time after receipt of your notice of such an offer, then you can proceed to complete the sale or transfer to the third party purchaser.

One problem with this right of first refusal is the response time the franchisor has to exercise this right. In some agreements the allowable period is several months, during which the third party buyer is left on hold. In your original agreement, you should try to negotiate for a more reasonable period of 15 to 30 days for the exercise of this right of first refusal.

IV. Buying a Franchise

A. Finding a Franchise Business

Perhaps the most common source of preliminary information regarding available franchises is newspaper advertisements. Canada's major business newspapers such as ***The Financial Times, The Financial Post*** and ***The Globe and Mail,*** all have special sections devoted to franchise advertisements. The business section or the business opportunities section of the classified advertisements in your local newspaper, such as ***The Winnipeg Free Press***, can also be an important location to look for prospective franchise situations. Business journals and trade magazines may also contain ads for many franchise organizations. Recommendations from friends, trade shows and seminars, and business opportunity shows often held in our larger cities can also be excellent means of contacting franchisors.

Another important source of information is franchise directories. These directories list franchisors' names and addresses along with information on the type of franchise offered, the costs involved and other useful information. Two important directories are the ***Franchise Annual*** published by Info Press Inc. in St. Catherines, Ontario and the ***Franchise Opportunities Handbook*** published by the United States Department of Commerce and available from the Superintendent of Documents in Washington, D.C.

B. Checking Out the Franchise Opportunity

After sifting through the various choices available, most prospective franchisees narrow their selection down to one or two possibilities. The next step is requesting a promotion kit from each of these franchisors. Normally this kit contains basic information about the company, its philosophy, a brief history, the number of outlets and where they do business. Most kits also contain an application form requesting your name and address as well as information about your past business experience, the value of your net assets and other data. For the process to continue with the franchisor, you must fill in this form in complete detail.

Before calling in outside help or signing anything, however, Robert Harris, a consultant with the international franchise consulting firm of Robert Harris and Associates of Toronto has developed a checklist outlining some basic homework for prospective franchisees. These steps include:

1. Check the franchisor's credit background with Dun and Bradstreet and your banker. Also ensure that the Better Business Bureau has not received any major complaints against the franchisor.
2. Request and analyze, if available, the franchisor's most recent financial statements as well as a list of its principal executives. This is simple if the franchisor is a public company. Smaller franchisors, however, may not want to disclose such information so it may be necessary to rely on information from banks and other credit agencies.
3. Obtain from the franchisor all the public information available on its operations. If it offers franchises in Alberta or in the United States, detailed documents have already been prepared and should be readily available. If, however, they are reluctant to give them to you, it is a bad sign. However, for smaller regional franchises in Canada, these documents may not exist.
4. Ask for a copy of the franchisor's trademark application or registration. Without it, the franchisor can give you no assurance of its ability to protect its own trademark, which could lead to later problems for franchisees.
5. Request a list of franchisees with their locations and telephone numbers. Discuss with a number of them the success and profitability of their outlets. Ask them how much time they spend on the business since this will affect their personal lifestyle. Also have these franchisees assess how well the franchisor has lived up to any promises. Do they feel they are getting something of value for their monthly royalty payments?
6. Complete the application or prescreening form if required by the franchisor. Fill in the financial information about yourself as accurately as possible. The franchisor should want to check out your financial background as carefully as you checked out their situation. If not, it is a bad sign.
7. Obtain a full set of legal documents from the franchisor — the franchise agreement as well as registered user agreements, leases or subleases and assignment agreements.
8. If a deposit is required, read the deposit agreement carefully and ensure that it is refundable. If not fully refundable, be sure that you will get at least 80-90% back. At this point, you must be satisfied with the franchisor's credibility and integrity.
9. The franchisor should offer an acceptable site (if applicable) for your business. Visit the site and analyze any available descriptive material, paying special attention to surrounding population, average annual income and age distribution. For major investments exceeding $100,000, you may want to call in a professional to confirm the franchisor's report.
10. Review the pro forma financial statements with an accountant.
11. If your accountant has given you the green light, inform your banker fully about your plans. Come prepared to this meeting and try to get the banker onside immediately because supporting evidence will be required to grant you a loan. Obtain all the information about franchising available from the bank, as well as any specific financing packages related to the franchise you are buying. Discuss your eligibility for various loan programs available from the bank to finance the remainder of your investment.
12. Inform your spouse and family completely about what you are doing. In most cases, your spouse will be required to guarantee the loan. In addition, you should assume that the whole family may also be physically and emotionally tied up in the business.
13. Engage a lawyer who specializes in franchise-related matters to review all of the documents including the trademark registration. As well, have an accountant take a final look at the franchise agreement as to any unfavourable tax implications.
14. Finally, as the ultimate decision will rest with you, it is now time to apply as much common sense as possible. Try to answer objectively whether you are reasonably suited to the proposed franchise business. Are you willing to make a total commitment in order to succeed? Be honest with yourself — franchising isn't for everyone.

C. Applying for a Franchise

As previously mentioned, the first step in applying for a franchise is to complete an application form with various information about yourself and your personal assets. This application form may be called by any one of a number of titles such as:

— confidential information form;
— personal history;
— confidential application;
— franchise application;
— pre-interview form;
— qualification report;
— credit application;
— application for interview form;
— request for interview.

Regardless of which of these titles is at the top of the form, they are all different ways of describing the same thing and request much the same information. This form normally requests a variety of information about you personally. For example:

— personal data such as your name, address, telephone number, age, health and physical impairments, marital status and number of dependents, and the name of any fraternal, business or civic organizations to which you might belong;

— business data such as your present business or corporation, your position, the name and address of your employer, how long you have been involved in this business, your present annual salary, and any previous business history that you may have;

— references such as your present bank and the name and address of your bank manager, and any other references that you may care to provide;

— financial data such as your average annual income for the past five years, and a total declaration of your current assets and liabilities to establish your net worth;

— in addition, the franchisor may also have several specific questions that relate to your particular interest in the franchise.

The application form normally requires you to provide a deposit, typically in the range of $2,000 to $5,000. In most cases the form will state that this deposit will be credited towards the initial franchise fee without interest or deduction if the transaction should proceed. However, you should make sure that if you are turned down, all or most of this deposit will be refundable. If it is a large amount of money and nonrefundable, especially for a new unproven franchise, it may be an investment opportunity you should overlook.

If your application is approved, the franchisor will interview you to determine your suitability as a franchisee. The focus of this interview will be on assessing your capability as a potential franchisee according to various objective criteria that have been established by the franchisor. Each franchisor will have established a set of selection criteria based on previous experience with various kinds of people within the system. For example, many franchisors will not consider absentee owners and refuse to grant franchises strictly for investment purposes. They feel that the success of their system rests on the motivation created by individually owned and managed outlets.

The personal characteristics desired by the franchisor will vary with the type of business. For example, a different level of education is necessary to operate a management consulting service than is needed to operate a carpet cleaning firm. Research on these selection criteria indicates that many franchisors tend to rank them in the following order in the selection of appropriate franchisees:

1. Credit and financial standing.
2. Personal ability to manage the operation.
3. Previous work experience.
4. Personality.
5. Health.
6. Educational background.

While other factors may also be considered by particular franchisors, these criteria tend to predominate the selection process.

This interview is also an opportunity for you to raise questions about the franchisor's financial stability, trademark protection policy, the ongoing services provided to franchisees, information regarding any financial packages that may have been arranged with particular chartered banks, the names and addresses of current franchisees, and any other questions that may come to your mind. For both sides, this is an opportunity to assess each other to see if you can work together on a long term basis. It is sometimes said that a franchise relationship is quite comparable to a marriage relationship, although it is suggested that you should exercise even greater care in the selection of a franchise partner than a marriage partner.

At this interview, the franchisor will also provide you with a copy of the franchise agreement or contract outlining the responsibilities of both sides after the business is started. At this point, you must evaluate all the available information with the help of your accountant, your bank manager, and your lawyer in order to ensure that you feel comfortable with the franchisor and that you are happy your investment is secure. If you have any remaining questions or doubts, now is the time to resolve them. Then, if you are still not completely sure in your own mind that you wish to proceed with the franchise, you should ask for a refund of your deposit.

Well-established and popular franchisors are unlikely to change their arrangements very much in response to your requests. They have successful systems in which many prospective franchisees would like to participate. As a result, they aren't likely to change their legal documentation very much to accommodate you. For them, it's a seller's market.

If one of these franchisors accepts you as a franchisee, you may have to make up your mind very quickly. It is important to be decisive. If you are comfortable with the franchisor and the franchise agreement, you should be ready to sign. If not, you should ask for a refund and pursue other opportunities.

Some franchisors will expect you to sign the franchise contract right away. Others wait until they have found a suitable location for your franchised outlet, actually within a predetermined period of time. In some cases it can take weeks, sometimes even months, for a suitable site to be found or a lease negotiated before you actually sign the franchise contract. In other cases, popular franchisors often have long waiting lists of prospective franchisees so that one or more years can pass before you will be in business with that franchisor.

D. Franchise Financing

One of the first steps in evaluating any franchise opportunity is to determine the total cost of getting into the business. This could include the initial franchise fee, real estate rental, equipment costs, start-up inventories and expenses, and initial working capital requirements. Then you must determine how much of this amount must be put up as an initial investment and what kind of terms might be arranged for handling the balance. Most franchisors expect the franchisee to put up 30-50% of the total franchise package cost as an initial investment. Do you have enough unencumbered capital to cover this amount?

The amount of the initial investment required can vary substantially depending upon the type of franchise business. For example, the initial investment required for a restaurant franchise can be substantial. The total franchise package cost for a typical fast food, take-out franchise with 30-40 seats might range from $150,000 to $300,000; the total cost of a full service restaurant can run from $400,000 to well over $1 million. In these cases, equipment and leasehold improvements tend to make up the largest component of the total cost.

In the retail sector the size of the required initial investment will vary depending upon the nature and location of the outlet. For example, a video store can require a total investment of from $100,000 to $150,000 with the franchisee being required to put up $40,000 to $50,000 initially. A computer store or a retail building supply dealership might require a total investment of $300,000 to $400,000 with a proportionately larger initial investment required on behalf of the franchisee. Most of this investment is typically in inventory.

The initial investment required for a service franchise is usually much lower. Many service franchises can be established for a total investment of less than $50,000. For example, a hair salon can usually be established for a total investment ranging from $30,000 to $50,000. Similarly, a carpet, drapery and upholstery cleaning service can be established for a total investment of between $10,000 and $30,000. A residential house cleaning and maid service franchise can be established for an investment of less than $15,000. At the other extreme, opening a franchised hotel or motel may involve a total investment of several million dollars, although the initial investment may be fairly small since the land and buildings for the motel can often be externally financed.

There are a number of sources and a variety of financing techniques that you might use to obtain the remaining capital. Some of the more popular ones include:

1. Short-term Financing

Short-term financing may be necessary to cover the purchase of assets having a very short life, such as small equipment, fixtures, and furniture, or to partially finance your inventory. The most common source of short-term financing is trade credit. Once you have established yourself with your suppliers, the majority of your purchases will be made on credit. This can mean that, depending upon the payment terms, you may be able to use the services/supplies received without cost for anywhere up to 60 days. To most businesses, this type of trade credit is an important source of short-term financing.

Another source of short-term capital is unsecured bank loans. They may be used for financing your inventory during peak periods, accounts receivable financing, special promotions, and other working capital items. These short-term loans are usually negotiated for a specific period of time; for example, 30, 60, or 90 days. They are commonly repayable in a lump sum at the end of this period.

A variation of the bank loan is the line of credit. This is an agreement between you and the bank or other financial institution specifying the maximum amount of credit you will be allowed at any one time. The amount of credit the bank might be prepared to extend will be a function of its assessment of the financial strength of your franchise.

2. Intermediate-term Financing

The most common way to obtain intermediate-term financing is through secured loans, term loans, or installment financing. Term loans typically vary in length from one to five years and can be arranged to cover the purchase of basic inventory, leasehold improvements, and other assets such as furniture, fixtures, and equipment. Generally, 60 to 75% of the cost of these items can be obtained from term loans. These loans are usually arranged through the chartered banks or other financial institutions. Repayment of these loans is typically geared to the franchise's financial situation and payments may be made monthly, quarterly, semi-annually, or annually.

Installment financing may be used to finance the purchase of equipment and fixtures where term loans are not available. Some furniture and equipment suppliers may finance their merchandise this way directly, but others will sell to a finance company which, in turn, will provide the installment financing. Installment loans of this type are generally secured by a chattel mortgage or a lien on the assets financed.

Another method of financing equipment and fixtures is leasing. A lease is a contractual arrangement in which the leasor may grant you (the leasee) the right to use the assets for a specified time in return for periodic rental or lease payments. Some franchisors and suppliers of equipment will lease to you directly. In other cases, you will lease from a company which specializes in leasing or a finance company which has bought the equipment from the supplier.

3. Long-term Financing

Long-term financing is typically used to finance the acquisition of major assets such as land, buildings, and to a lesser degree, major pieces of equipment. In most franchise situations you are leasing your building, or land and building. As a result, your need for long-term financing may be quite small.

A variety of different methods can be used for raising long-term capital, but mortgage debt and the sale of equity have been the two most popular methods. Mortgage loans may be obtained from insurance companies, pension funds, commercial bankers, and, in some cases, the franchisor. These mortgage loans can usually be obtained for from 70-75% of the appraised value of the land and buildings offered as security for the loan. Long-term loans usually run for a maximum of 20 to 25 years with the interest rate being negotiated every 5 years. In some cases, the term may be tailored to the length of your franchise contract. Even if your business is incorporated, it is not uncommon for the mortgage lender to require your personal guarantee of the loan in case your company doesn't meet its outstanding debt obligation.

In order to borrow from external financial institutions, these institutions normally expect you to have a substantial financial interest or investment in the business. This equity investment should range from 25-50% of the total investment in the venture and might come from your own savings or from friends or relatives willing to invest in your business.

This equity investment could be in the form of shareholder loans, common stock or shares in the company, or a combination of loans and shares. How the investment is structured will vary in each situation.

Typically, very few franchisors provide direct financial assistance to their franchisees. However, some will guide and assist new franchisees in obtaining financing from traditional financial institutions. Many franchisors have directly contacted the franchising section of a number of Canada's major chartered banks to inform the bankers about their franchise program and their overall financial situation. This can facilitate obtaining financing for franchisors who qualify with the bank and franchisees who meet the bank's normal loan criteria.

Many franchisees may be eligible for loans under the Small Businesses Loans Act (SBLA). The Small Businesses Loans Act is available to new small business enterprises whose annual gross sales will not exceed 2.0 million dollars. These loans are available for: the purchase of fixed or moveable equipment, the purchase or construction of new premises or the improvement of existing premises, or the purchase of land for the operation of a business. These loans may not be used to meet the company's working capital requirements or to repay an existing loan.

At the present time, the maximum amount that you may borrow under the Act at any one time is $100,000. Subject to this maximum, these loans may be used to finance up to 80% of the cost of fixed or moveable equipment or 90% of the cost of the purchase or construction of new premises or the purchase of land.

The rate of interest on SBLA loans is 1% over the prime rate of the chartered banks, and it fluctuates with changes in the prime rate during the term of the loan. The maximum term of a loan is 10 years.

All chartered banks, Alberta Treasury Branches, and a number of credit unions, caisses populaires, trust companies, loan companies, and insurance companies which have been specifically designated as lenders are authorized to make loans under the SBLA.

Knowing what is involved in security financing can give you a distinct advantage. Banks consider a number of questions in deciding who qualifies for a franchise financing package. These questions include:

1. Does the franchisor offer a quality product or service satisfying a market need? Is consumer demand strong?
2. How long has the franchisor been in business? What is his/her record of growth and profitability? Has a good reputation been established?
3. Has the franchisor developed equitable legal agreements and are they enforceable for the protection of all parties?
4. Does the franchise fee bear a reasonable relationship to the total cost of the franchise, and what does the franchisee get in return for it?
5. Where is the franchisor's revenue generated? Is most of it made at the "front end" from the sale of franchised outlets, or over the long-term through the continuing distribution and sale of a product or service?
6. What commitment does the franchisor have to the success of the system? Are the land and buildings owned by the franchisor? Is the franchisee's lease guaranteed by the franchisor?
7. Is the franchisor willing to provide buyback agreements or letters of comfort to support loans to franchisees?
8. Does the franchisor have the financial stability to meet his/her responsibilities to prospective franchisees?

Before approaching any commercial lender, a great deal of advance preparation is normally required. You should prepare, and be prepared to present to the lender a formal plan outlining such factors as who you are, what your plans are, how much money you require, and what these plans and funds will do for the business. This plan should normally contain such information as:

1. An overview of the business;
2. The amount of the loan requested and its purpose;
3. Proposed repayment terms;
4. The debt/equity ratio of the business after the loan has been received;
5. The security or collateral to be offered for the loan;
6. Personal information on yourself and anyone else owning a substantial equity interest in the business. This should include your previous education and work history, credit references, income tax statements for the past 3 or 4 years, and a current financial statement;
7. Detailed information on your proposed business such as a comprehensive business plan including financial projections of profit and losses and expected cash flow;
8. Copies of any life and liability insurance policies; and,
9. Copies of any relevant lease agreements.

The presentation of this information and the plan should be thorough but not fancy. It should be prepared well in advance of the initial contact with any prospective lender.

V. Final Comments

A. Future Trends in Franchising

The United States Department of Commerce has identified a number of important trends that are likely to be evident in franchising throughout the rest of the 1980's. Amongst the most important of these are:

1. The growth of Conversion Franchising — conversion franchising refers to the conversion of an independent business to a franchise. The idea is not new, and in the past has been used extensively in real estate franchising. The movement to conversion franchising is expected to be evident in many other areas, however, especially in construction, home repair and remodelling services, all types of business services, non-food retailing and restaurants.
2. Women are expected to become involved in franchising in numbers larger than ever before, both as franchisors and franchisees. Franchising offers new opportunities for women who are entering the professional and management ranks and want to be part of the business world or to invest in an independent business career. Starting their own businesses through franchising decreases the risk factor for women with little or no previous business experience. Furthermore, women often excel in businesses that cater specifically to the needs or interests of other women.
3. Changing consumer lifestyles and the new status of working women in society are expected to influence the growth of franchising, particularly in terms of non-food retail stores that provide a variety of services for the home. Accelerated growth is expected in franchise stores providing home furnishings, decorating, picture framing, and other types of accessories for the home. Growth is also expected to take place in all types of general merchandise, video, and electronic stores.
4. Computer technology is expected to have a dramatic impact on the service sector, and especially franchising. The computer industry is establishing new businesses in the form of franchised retail stores and this trend is expected to continue. Although competition will intensify and other distribution channels emerge, franchisors of computer stores will focus on two separate markets. One is the computer store specializing in home computers, video games, software, and hardware, and the other is the store providing for the needs of businesses with support services and systems.
5. Dental health care has become an integral part of franchising as franchised dental centers have spread to all regions of Canada and the United States. This trend is expected to continue to develop rapidly as dental care expenditures rise and the application of modern business methods by dental franchisors provide increased efficiency, greater service, and lower fees, while meeting the needs of the huge, untapped dental patient market.
6. Franchised restaurants of all types are expected to continue to be the most popular sector of franchising. Increased activity is expected in the up-scaling of franchised restaurants in terms of exterior and interior decor, service, and quality and variety of food items served. Franchisors of restaurants, especially those whose major product is pizza, have been among the fastest growing outlets and this trend is expected to continue for the next few years.
7. Franchises that specialize in automotive repairs will continue to grow in many areas of the huge automotive aftermarket. This trend will continue to expand through the next decade. Traditional sources of automotive repair are disappearing with the continuing decline of new car dealerships and full-service gasoline service stations. In addition, the automobile population is growing annually in both number and variety and the average age of cars on the road is getting older. Franchise growth will be in specialized automotive centers providing services in tune-up, quick lube, muffler repair and replacement, transmissions, brakes, painting, electrical repairs, and general car care.
8. Other areas of franchising that bear watching over the next few years are automobile leasing, packaging and rapid delivery of parcels, home building, medical centers, temporary health services, and business brokers. More franchising is also expected in printing and copying services, weight control centers, and hair salons for both men and women.
9. Convenience stores, emphasizing speed and service, provide the multiple "fill-in" items that consumers need between their regular trips to the supermarket. Growing numbers of convenience stores are realizing extra sales by installing self-service gasoline pumps on their premises. Also, in order to increase their sales volume and compete with fast-food restaurants, many convenience stores are offering a wide variety of take-out foods. This segment of the franchise industry is expected to continue to grow at a dramatic rate.
10. Businesses engaged in franchising educational services are becoming highly specialized. For example, increased leisure time has created a growing market for dietary and exercise training centers; this area has been successfully exploited by franchise system. Franchisors have also entered the growing field of early childhood education with the establishment of day care centers with modern learning and play equipment. Sales of this segment of the franchise industry are expected to continue to increase quite dramatically.

Appendix I
Sources of Additional Information

1. Franchise Associations and Other Organizations

Further information and assistance in the investigation of any franchise organization may be obtained from the following sources:

1. Alberta Securities Commission
   10th Floor, Capital Square Building
   Edmonton, Alberta
   T5J 3B1
   Telephone (403) 427-5201.
2. Federal Trade Commission
   6th and Pennsylvania Avenue, N.W.
   Washington, D.C.
   20580
   Telephone (202) 376-2805.
3. The Association of Canadian Franchisors
   44 Laird Drive
   Toronto, Ontario
   M4G 3T2
   Telephone (416) 429-1514.
4. The International Franchise Association
   1025 Connecticut Avenue, N.W. Suite 1005
   Washington, D.C.
   20036
   Telephone (202) 659-0790.
5. The British Franchise Association
   Franchise Chambers, 75A Bell Street
   Henley-on-Thames, Oxon RG9 2BD
   England
   Telephone (0491) 57849.

2. Other Books, Pamphlets and Brochures on Franchising

1. ***The 1985 Franchise Annual,*** Info Press Inc., 11 Bond Street, St. Catherines, Ontario, L2R 4Z4.
2. ***Franchise Opportunities Handbook,*** United States Department of Commerce, Superintendent of Documents, United States Government Printing Office, Washington, D.C., 20402, 1984.
3. ***How to Buy a Franchise,*** available from the various offices of Thorne, Riddell across Canada.
4. Coltman, M.N., ***Franchising in Canada: Pros and Cons,*** International Self Counsel Press Ltd., Vancouver, B.C., 1982.
5. ***International Franchise Association, Directory of Membership,*** International Franchise Association, 1025 Connecticut Avenue, N.W., Suite 1005, Washington, D.C., 20036.
6. International Franchise Association, ***Answers to the 21 Most Commonly Asked Questions About Franchising,*** International Franchise Association, 1025 Connecticut Avenue, N.W., Suite 1005, Washington, D.C., 20036.
7. Pilot Industries, Inc., 103 Cooper Street, Babylon, N.Y., 11702. Publishes a number of helpful publications relating to various areas of franchising.

Appendix II
Checklist For Evaluating A Franchise

The Franchise

1. Did your lawyer approve the franchise agreement you are considering after studying it paragraph by paragraph?
2. Does the franchise agreement call upon you to take any steps which are, according to your lawyer, unwise or illegal in your province, country or city?
3. Does the franchisor give you an exclusive territory for the length of the agreement or can he sell a second or third franchise in your territory?
4. Is the franchisor connected in any way with any other franchise company handling similar merchandise or services?
5. If the answer to the previous question is "yes", what is your protection, if any, against this second franchise organization?
6. Under what circumstances can you terminate the franchise contract and at what cost to you, if you decide for any reason that you wish to cancel it?
7. If you sell your franchise, will you be compensated for your goodwill or will the goodwill you have built into the business be lost by you?

The Franchisor

8. How many years has the firm offering you a franchise been in business?
9. Has it a reputation for honesty and fair dealing with its other franchisees?
10. Has the franchisor shown you any certified figures indicating exact net profits of one or more other franchises which you have personally checked yourself with the franchisee?
11. Will the firm assist you with:
    a. A management training program?
    b. An employee training program?
    c. A public relations program?
    d. Capital?
    e. Credit?
    f. Merchandising ideas?
12. Will the firm help you find a good location for your new business?
13. Is the franchising firm adequately financed so that it can carry out its stated plan of financial assistance and expansion?
14. Is the franchisor a one-person company or a corporation with an extensive and experienced management team?
15. Exactly what can the franchisor do for you which you cannot do for yourself?
16. Has the franchisor investigated you carefully enough to ensure that you can successfully operate a franchise at a profit to both parties?
17. Does your province have any laws regulating the sale of franchises and has the franchisor compiled with those laws?

You — the Franchisee

18. How much equity capital will you need to purchase the franchise and operate it until your income equals your expenses? Where are you going to get it?
19. Are you prepared to give up some independence of action to secure the advantages offered by the franchise?
20. Do you really believe you have the innate ability, training, and experience to work smoothly and profitably with the franchisor, your employees, and your customers?
21. Are you ready to spend much or all of the remainder of your business life with the franchisor, offering his or her product or service to your public?

Your Market

22. Have you made any effort to determine whether the product or service which you propose to sell under franchise has a market in your territory at the prices you will have to charge?
23. Will the population in the territory given you increase, remain static, or decrease over the next 5 years?
24. Will the product or service you are considering be in greater demand, about the same, or less demand 5 years from now than today?
25. What competition already exists in your territory for the product or service you contemplate selling?
    a. Nonfranchise firms?
    b. Franchise firms?

Adapted from: ***Franchise Opportunities Handbook,*** United States Department of Commerce, October, 1984, pp. xxxi.

The Department of Business Development and Tourism thanks Dr. Walter Good, of G & B Research Associates, for the preparation of this document. Additional copies are available at the Business Development Centre, 2nd floor, 1329 Niakwa Road, Winnipeg, Manitoba R2J 3T4 (telephone: (204) 945-7738).